Testimony of David C Garlock before the
Select Revenue Measures Subcommittee of the
Committee on Ways and Means
US House of Representatives

Hearing on Ways and Means Financial Products
Tax Reform Discussion Draft
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Good afternoon. My name is David Garlock. I am a principal in the National Tax Department of Ernst & Young LLP, based here in Washington, DC. My practice is devoted almost entirely to the taxation of financial instruments, with a particular focus on the taxation of debt. I am the principal author of a treatise called *Federal Income Taxation of Debt Instruments.* I am testifying today on my own behalf to provide technical guidance to the Subcommittee and not on behalf of Ernst & Young LLP or any of its clients.

The Ways and Means Financial Products Tax Reform Discussion Draft of January 23, 2013 (the "Discussion Draft") includes four provisions relating to the taxation of debt instruments. Two are minor provisions, and I won't discuss these today.

The other two provisions are designed to address problems under current law with the tax treatment of so-called "distressed debt." This phrase refers to debt that is owed by a borrower that is having financial difficulties, so that there is a serious risk that the borrower will not be able to pay the full amount owed on the debt. Both of these provisions are drawn from a Report of the American Bar Association Tax Section Committee on Financial Instruments submitted to Congress in December 2011 (the "ABA Report"). I was one of the co-authors of the ABA Report and had significant responsibilities for the parts of the report dealing with the taxation of debt instruments.

The first major debt-related provision in the Discussion Draft deals with the consequences of a debt modification. Generally, this provision prevents a borrower from having taxable income when its debt is modified merely because the debt is publicly traded at a discount. Congress provided a temporary fix to this problem in 2009 with the enactment of Internal Revenue Code section 108(i), but this provision expired at the end of 2010. I believe that the Discussion Draft provides a better approach to this problem than section 108(i) and that the Discussion Draft's approach should be enacted. The Discussion Draft does not address a corresponding problem for investors in distressed debt, and I believe that the companion provision included in the ABA Report to address this problem, which I describe briefly below, should be added to legislation as it moves forward.

The second of the two major debt provisions addresses the treatment of market discount. Market discount arises when debt changes hands in the secondary market at a price that is lower than the debt's face amount. Market discount can arise either because prevailing interest rates have risen since the debt was issued, or because the borrower is in financial distress, or a combination of the two.

As a general matter, the problem with current law rules governing market discount is that they do not distinguish between the two potential sources of market discount. The provisions in the Internal Revenue Code governing the taxation of debt were enacted mostly in 1982 and 1984, and at that time prevailing interest rates were at historic highs rather than the current historic lows. When interest rates are high, notes, bonds and other debt instruments trade at significant discounts having nothing to do with the borrower's financial distress. Accordingly, the rules governing debt trading at a discount were written based on the implicit assumption that the discount was attributable exclusively to high interest rates, and not the borrower's financial difficulties. In the current low-interest rate environment, essentially the opposite is true, making the current rules governing the taxation of debt particularly in need of refinement.

The Discussion Draft would address this problem by placing a cap on the rate at which market discount accrues, which is designed to differentiate between the two sources of market discount. I think this would be a significant step in the right direction, and I support its enactment. Another aspect of the Discussion Draft would require taxpayers to include market discount in income as it accrues (subject to the yield cap). Under current law, this treatment is elective. I feel that there is considerable merit to this proposed rule as well, but I believe it deserves further analysis and discussion, as I will explain below.

Detailed Discussion

Tax Treatment of Transaction When Publicly Traded Debt Is Significantly Modified

Section 411 of the Discussion Draft would change the tax treatment of a transaction in which publicly traded debt is significantly modified. A significant modification of a debt is often necessary or at least desirable when a borrower is experiencing financial difficulties and is no longer able to meet the terms of its outstanding debt obligations. A modification might include extending the term of the debt, changing the interest rate, relaxing certain financial covenants in the indenture governing the debt, and/or changing the interest payment schedule from current-pay to one in which accrued interest is not payable until maturity.

If a debt instrument is significantly modified, it is deemed to be retired and reissued for an amount equal to the "issue price" of the modified debt. Under current law, the issue price of the modified debt is generally equal to its face amount if it is not publicly traded and is equal to its fair market value if it is publicly traded. Without going into detail, current IRS regulations take a broad view of what constitutes public trading.

This treatment poses a problem for borrowers whose debt is publicly trading at a discount. For example, suppose a corporation has borrowed $100 million and its notes are currently trading at 70 (meaning 70% of their face amount). If the notes are significantly modified, the borrower is treated under current law as having retired its notes for $70 million, even though it still owes $100 million. This $30 million difference is called income from the cancellation of indebtedness, referred to as "COD" income. COD income is generally currently taxable to the borrower unless it is insolvent.

Because the modified notes are deemed to have been issued for their trading price of 70 while their principal amount remains at $100 million, the notes now have $30 million of original issue discount (OID), which generally is deductible by the borrower over the remaining life of the modified notes as interest expense, although the interest deduction may be deferred or denied in part under the rules governing applicable high yield discount obligations. Thus, while the problem under current law is generally a timing problem, it can result in some cases in a permanent tax difference. Furthermore, even when the problem involves only timing, for a financially stressed borrower that has to pay the tax on the COD income in the year of the modification, the problem can be a serious one.

Section 411 in the Discussion Draft would change the tax treatment of significant modifications of publicly traded debt by providing in effect that the issue price of the modified debt would be determined as if the debt were not publicly traded. This means that the modified debt would be deemed reissued for its face amount (so long as it calls for stated interest at a rate not lower than the applicable Federal rate ("AFR")), so the issuer would have neither COD income nor OID deductions over the remaining life of the modified debt. As noted above, this would be a welcome change in the law.

The ABA Report contained another legislative proposal relating to modifications of debt that was not included in the Discussion Draft. I believe that this proposal also has significant merit and should be included in any legislative package dealing with this issue. This proposal affects investors in debt, not borrowers.

To see the problem on the investor side, suppose that an investor buys $10 million of the notes described above for a price of $7 million shortly before the notes are significantly modified. If the notes are not publicly traded, or if section 411 of the Discussion Draft becomes law, the investor is deemed to have realized $10 million on the exchange, which means that the investor has $3 million of gain. Assuming the notes are still worth 70% of face at the time of the modification, this might be described as "phantom gain" because it does not correspond to any true economic gain.

Whether that gain is currently taxable depends on whether the transaction qualifies as a tax-free recapitalization. In general terms, the transaction would so qualify only if the borrower is a corporation and the debt being modified is long-term debt. In other cases, the gain is taxable.

The proposal in the ABA Report that is missing from the Discussion Draft would broaden tax-free recapitalization treatment to all exchanges of debt instruments – gain or loss would not be recognized on the exchange, and the investor would carry over its basis in the old debt to the modified debt. This would avoid the inappropriate taxation of phantom gain without interfering with the tax treatment of the borrower.

Tax Treatment of Market Discount

Section 413 of the Discussion Draft would change the taxation of market discount in two important respects. The first change to the market discount rules is designed to create a distinction between market discount arising from increased interest rates and market discount arising from the borrower's financial distress. It does so by placing a cap on the yield at which market discount accrues equal to the greater of (i) the AFR at the time of purchase plus 10 percent or (ii) the original yield on the debt instrument plus 5 percent. For example, if a bond was issued with an original yield of 6 percent and the AFR at the time of purchase of the bond was 3 percent, the yield cap would be 13 percent.

I do want to point out a technical drafting problem with the proposal that should be fixed. As drafted, the capped yield applies not to the investor's actual purchase price of the debt but to a hypothetical amount obtained by discounting the remaining cash flows on the debt to present value on the purchase date at a yield equal to the capped yield. This can be considerably higher than the actual purchase price. For example, if a 6% note has 5 years remaining and the yield cap is 13%, the present value of the remaining payments is approximately 75% of the note's face amount, so the accrual in the first year would be approximately 13% of 75, or a bit less than 10. But if the investor purchased the note for say 40, the market discount accrual in the first year should be 13% of 40 = 5.2, not 13% of 75. Note that under current law, the accrual would be based on the investor's yield of approximately 30%, and so would be about 12 in the first year.

Assuming this technical problem is fixed, this proposal, if enacted, would greatly reduce the adverse effects of the market discount rules on investors in distressed debt. Further, it would be relatively easy to apply because it does not require a definition of distressed debt for tax purposes and does not result in dramatically different tax treatment depending on whether debt is classified as distressed or not. However, section 413 of the Discussion Draft does not fully address the tax problems from investing in distressed debt – for example, the accrual of stated interest on distressed debt. This problem has been addressed by case law.

Specifically, cases dating back to 1930 have held that, for an accrual-method taxpayer, accrued interest need not be included in taxable income if at the time of the accrual there is no reasonable expectation of collection. Accordingly, I believe it is important that the legislative history to this provision make clear that it is not intended to supersede common law rules governing distressed debt.

The second change made by section 413 of the Discussion Draft would be to require taxpayers to include market discount in income as it accrues, subject to the yield cap. This would conform the taxation of market discount to the taxation of OID, which has been subject to taxation on an accrual basis since 1982. The premise of this change is that once market discount is made subject to a yield cap, the remaining market discount is effectively equivalent to interest (like OID) and therefore ought to be subject to taxation as it accrues.

This change seems generally sound. If and when interest rates rise again, and debt is trading at a discount because of higher interest rates, a tax system that taxes market discount on a cash basis while taxing OID and stated interest on the accrual-method will create a tax incentive for taxpayers to invest in market discount bonds rather than newly issued bonds with higher stated rates. This may create distortions in the capital markets. Further, with the significant expansion of computing software since the market discount rules were enacted in 1984, investors should be able to undertake computations based on yield-to-maturity concepts even though they will not be receiving information reports from the borrower.

However, it is important to note that, even with a yield cap in place, market discount is not fully equivalent to interest and OID. Part of the rationale for requiring even cash-method taxpayers to include OID in income as it accrues is that borrowers are usually accrual-method taxpayers, and allowing OID to be reported on the cash method would create a mismatch between borrower deductions and investor inclusions. This is not true of market discount, for the borrower has no deduction corresponding to the investor's market discount income. Further, for an investor in deeply distressed debt, it is not clear that any portion of the market discount is equivalent to interest, with or without a yield cap. For example, if a borrower is on the verge of failure, its debt will trade at a price largely determined by what an investor could expect to collect in a bankruptcy proceeding. That amount does not grow over time based on an interest-like accrual; it is determined entirely by the value of the borrower's assets and the debt's priority relative to other creditors.

Conclusion

I appreciate the opportunity to appear before the Subcommittee. I hope that my input has been helpful and will further inform your considerations. I would be happy to any questions the Chairman or other members of the Subcommittee might have.